SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 19b-4

Proposed Rule Change

by

THE OPTIONS CLEARING CORPORATION

Pursuant to Rule 19b-4 under the
Securities Exchange Act of 1934

Item 1. **Text of the Proposed Rule Change**

In order to permit certain of its Clearing Members to take advantage of more favorable net capital requirements applicable to contractual obligations to counterparties with which the Clearing Member has an enforceable netting agreement, The Options Clearing Corporation ("OCC" or the "Corporation") proposes to amend its By-Laws and Rules to provide for close-out netting procedures to be followed in the highly unlikely event that OCC were to become insolvent. The procedures include notifying the Clearing Members and other interested persons and carrying out an orderly and efficient liquidation of outstanding cleared contracts, making maximum use of netting under the protection of Title IV of the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") and applicable provisions of the U.S. Bankruptcy Code.

The proposed rule change will add a new Section 26 in Article VI of the By-Laws. Because this section is entirely new, underlining ordinarily used to mark textual additions has been omitted to facilitate readability.

THE OPTIONS CLEARING CORPORATION

BY-LAWS

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ARTICLE VI

Clearance of Exchange Transactions

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Close-Out Netting

SECTION 26. (a) *Insolvency of the Corporation.* If the Corporation determines that it is insolvent or commences a voluntary case under Chapter 7 of the U.S. Bankruptcy Code (the "Code"), or if an involuntary case under Chapter 7 of the Code is commenced against the Corporation and is not dismissed within 30 days, the Corporation or its representative shall promptly notify the Securities and Exchange Commission, the Commodity Futures Trading Commission, the Clearing Members, any clearing organizations with which the Corporation has cross-margining or cross-guarantee arrangements, and all Exchanges, futures markets and security futures markets for which the Corporation clears Exchange transactions. Such notice shall state the nature of the event that has occurred, that effective as of a specified time on a specified date (the "Termination Time") the Corporation will accept no more Exchange transactions for clearing, and that all pending transactions, positions in cleared contracts and stock loan and borrow positions remaining in all accounts of all Clearing Members at the Termination Time will be valued as of the Termination Time and liquidated in accordance with this Section 26 of the By-Laws. Such liquidated positions shall be netted to the maximum extent permitted by law and the By-Laws and Rules, and settlement of the net amounts shall be effected in the manner provided by this Section 26 in satisfaction of all obligations owing between the Corporation and Clearing Members in respect of such positions. The provisions of this Section 26, other than paragraph (k) below, shall not apply to the disposition of assets and liabilities in any X-M account provided for in Article VI, Section 24 of the By-Laws. From and after the Termination Time the rights of Clearing Members against the Corporation shall be limited to those set forth in this Section 26 and applicable bankruptcy law. In the event that a Clearing Member is suspended by the Corporation pursuant to Chapter 11 of the Rules or the Corporation suffers a loss from any cause that is chargeable against the Clearing Fund in accordance with the By-Laws and Rules, whether such suspension or loss occurs before or after the Corporation gives a notice under this paragraph (a), the provisions of paragraph (l) below shall apply.

(b) *Valuation.* The Corporation shall fix a U.S. dollar amount (the "close-out value") to be paid to or received from the Corporation with respect to each short or long position in cleared contracts and each stock loan and borrow position in each account of each Clearing Member. In fixing close-out values, the Corporation shall exercise its discretion, acting in good faith and in a commercially reasonable manner, in adopting methods of valuation expected to produce reasonably accurate substitutes for the values that would have been obtained from the relevant market if it were operating normally, including but not limited to the use of pricing models to determine a value for a cleared contract based on the market price of the underlying interest or the market prices of its components. In determining a close-out amount, the Corporation may consider any information that it deems relevant, including, but not limited to, any of the following:

(1) prices for underlying interests in recent transactions, as reported by the market or markets for such interests;

(2) quotations from leading dealers in the underlying interest, setting forth the price (which may be a dealing price or an indicative price) that the quoting dealer would charge or pay for a specified quantity of the underlying interest; and

(3) relevant historical and current market data for the relevant market, provided by reputable outside sources or generated internally.

(4) values derived from theoretical pricing models using available prices for the underlying interest or a related interest and other relevant data.

Amounts stated in a currency other than U.S. Dollars shall be converted to U.S. Dollars at the current rate of exchange, as determined by the Corporation. A position having a positive close-out value shall be an "asset position" and a position having a negative close-out value shall be a "liability position."

(c) *Netting Within Accounts.* The Corporation shall net the close-out values of positions in each account of each Clearing Member to determine the net asset position or net liability position in each account as follows:

(1) Aggregate the close-out values of all asset positions (excluding segregated long option positions in a securities customers' account or firm non-lien account), aggregate the (negative) close-out values of all liability positions, and net the aggregate asset position against the aggregate liability position.

(2) The aggregate close-out value of segregated long option positions in a securities customers' account or firm non-lien account shall be identified as constituting the property of the securities customers of the Clearing Member and held for distribution to the persons entitled thereto in accordance with applicable law.

(d) *Netting Across Accounts.* The Corporation shall determine the total net asset position or the total net liability of the Clearing Member by netting across the Clearing Member's accounts as follows:

(1) A net asset position in the firm account, a proprietary Market-Makers' account or any other proprietary account (other than a proprietary X-M account) may be netted against a net liability in any other account.

(2) A net liability in a firm account, proprietary Market-Makers' account or any proprietary account may be netted against a net asset position in any other proprietary account (except a proprietary X-M account).

(3) A net asset position in a combined non-proprietary Market-Makers' account or a separate non-proprietary Market-Maker's account shall not be netted against a net liability position in any other account and shall be identified as the property of securities

customers of the Clearing Member and held for distribution to the persons entitled thereto in accordance with applicable law.

(4) A net asset position in the segregated futures account shall not be netted against a net liability in any other account and shall be segregated and identified as property of the futures customers of the Clearing Member and held for distribution to the persons entitled thereto in accordance with applicable law.

(5) A net asset position in the internal non-proprietary cross-margining account shall not be netted against a net liability in any other account and shall be segregated and identified as property of the futures customers of the Clearing Member and held for distribution to the persons entitled thereto in accordance with applicable law.

The result of all permitted netting shall be the total net asset position or total net liability position of the Clearing Member with respect to its positions in cleared contracts and stock loan and borrow positions with the Corporation before application of margin assets as provided in paragraph (e) hereof.

(e) *Application of Cash Margin Assets.* Any restricted margin deposited by a Clearing Member in the form of cash shall be applied to the reduction of any net liability in the account or accounts of the Clearing Member to which such margin may be applied in accordance with the applicable restrictions, and the Clearing Member's total net liability position shall be reduced accordingly. The Clearing Member's total net liability position shall be further reduced by the amount of unrestricted cash margin deposited by the Clearing Member in respect of all of its accounts other than segregated futures accounts and X-M accounts. The resulting net amount shall be the Clearing Member's total net asset position or total net liability position (as the case may be) after application of cash margin assets. As used in this Section 26, the term "restricted margin" means any margin asset, whether in the form of cash, securities or a letter of credit, the use of which is limited to specified obligations of the Clearing Member either under the By-Laws and Rules, by any other agreement between the Corporation and the Clearing Member or by applicable law.

(f) *Liquidation Settlement.*

(1) The Corporation shall designate a liquidation settlement date, which shall be no earlier than the business day following the Termination Date.

(2) Any obligations of a Clearing Member to the Corporation, and any obligations of the Corporation to the Clearing Member, not included in the foregoing determination of the Clearing Member's total net asset position or total net liability position shall be reduced by netting to a single amount owed by the Clearing Member to the Corporation or by the Corporation to the Clearing Member. The resulting net amount shall be netted with the Clearing Member's total net asset position or total net liability position, as the case may be, to obtain a Net Settlement Amount.

(3) If a Clearing Member has a positive Net Settlement Amount, it has a claim against the Corporation for the value of that amount on the termination date and, as a general unsecured creditor of the Corporation, may file a claim for the amount thereof in the Corporation's bankruptcy case.

(4) If a Clearing Member has a negative Net Settlement Amount after application of available cash margin as described above, it shall pay the value of such position to the Corporation on the liquidation settlement date. If the Clearing Member fails to pay the full amount of any negative Net Settlement Amount on the liquidation settlement date, the provisions of paragraph (g) hereof shall apply.

(g) *Failure of Clearing Member to Pay Net Settlement Amount.* If a Clearing Member fails to pay any Net Settlement Amount to the Corporation when due, the Corporation shall liquidate all non-cash margin deposits as needed and shall apply the proceeds thereof to reduce the deficit; provided, however, that if the issuer of a letter of credit shall agree in writing to extend the irrevocability of its commitment thereunder in a manner satisfactory to the Corporation, the Corporation may, in lieu of demanding immediate payment of the face amount of the letter of credit, but reserving its right to do so, demand only such amounts as it may from time to time deem necessary to meet anticipated disbursements. Proceeds of any restricted margin deposited by a Clearing Member in the form of cash shall be applied to the reduction of any net liability arising from the account or accounts of the Clearing Member to which such margin may be applied in accordance with the applicable restrictions. If any portion of the Net Settlement Amount remains unsatisfied after application of margin deposits, the Corporation shall seek to satisfy the remaining deficit as follows: (i) first, apply the Clearing Member's clearing fund contribution (including any amounts obtained from the Clearing Member in satisfaction of its obligation to make good on any charges against its Clearing Fund contribution); and (ii) second, make a pro rata charge against the Clearing Fund contributions of other Clearing Members in accordance with the By-Laws and Rules.

(h) *Disposition of Remaining Margin Deposits.* If the Clearing Member is solvent and has not been suspended pursuant to Chapter 11 of the Rules, then any remaining restricted or unrestricted margin deposited by the Clearing Member and remaining after all permissible applications provided for above, shall be released to the Clearing Member to be treated and dealt with by the Clearing Member in accordance with applicable law. If the Clearing Member has been suspended by the Corporation pursuant to Chapter 11, then any restricted margin deposited by a Clearing Member and remaining after application of restricted margin to the full extent provided above shall be segregated to the extent required and held by the Corporation under an appropriate designation for distribution to the persons entitled thereto in accordance with applicable law. Any unrestricted margin remaining shall be held for distribution to the persons entitled thereto under applicable law.

(i) *Clearing Fund.* Any unused portion of a Clearing Member's Clearing Fund contribution shall be returned to the Clearing Member or held for distribution to the persons

entitled thereto under applicable law, as appropriate, at such time as the Corporation has determined (1) that it has been fully reimbursed for losses and expenses arising from any of the circumstances detailed in Article VIII, Section 5(a) and, subject to the restriction set forth therein, Section 5(b); and (2) that it is extremely unlikely that the Corporation will incur additional losses and expenses reimbursable from the Clearing Fund.

(j) *Interpretation in Relation to FDICIA.* The Corporation intends that certain provisions of this Section 26 be interpreted in relation to certain terms (identified by quotation marks) that are defined in the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA"), as amended, as follows:

(1) The Corporation is a "clearing organization."

(2) An obligation of a Clearing Member to make a payment to the Corporation, or of the Corporation to make a payment to a Clearing Member, subject to a netting agreement, is a "covered clearing obligation" and a "covered contractual payment obligation."

(3) An entitlement of a Clearing Member to receive a payment from the Corporation, or of the Corporation to receive a payment from a Clearing Member, subject to a netting contract, is a "covered contractual payment entitlement."

(4) The Corporation is a "member," and each Clearing Member is a "member."

(5) The amount by which the covered contractual payment entitlements of a Clearing Member or the Corporation exceed the covered contractual payment obligations of such Clearing Member or the Corporation after netting under a netting contract is its "net entitlement."

(6) The amount by which the covered contractual payment obligations of a Clearing Member or the Corporation exceed the covered contractual payment entitlements of such Clearing Member or the Corporation after netting under a netting contract is its "net obligation."

(7) The By-Laws and Rules of the Corporation, including this Section 26, are a "netting contract."

(k) *Cross-Margining Agreements.* If an event of insolvency of the type referred to in paragraph (a) of this Section 26 occurs, the Corporation shall immediately seek to exercise its authority under each Participating CCO Agreement to which it is a party to cause the immediate liquidation of all assets and liabilities in all X-M accounts of Clearing Members subject to such agreements and to reduce such account to a single net obligation to or from the Clearing Member or Pair of Affiliated Clearing Members to be settled in accordance with the terms of the applicable Participating CCO Agreement.

(l) *Clearing Member Suspensions; Charges Against the Clearing Fund.* In the event that a Clearing Member is suspended by the Corporation pursuant to Chapter 11 of the Rules after a notice has been given by the Corporation pursuant to paragraph (a) of this Section 26 or prior to the time when the Corporation has completed the liquidation of a previously suspended Clearing Member's accounts as provided in Chapter 11, the Corporation shall liquidate, or continue to liquidate, the Clearing Member's accounts as provided in Chapter 11 to the extent practicable and not inconsistent with this Section 26; and any amounts owing between the Corporation and the Clearing Member as a result of such actions shall be included in determining the Clearing Member's Net Settlement Amount under this Section 26. If the Corporation suffers a loss as the result of such a Clearing Member liquidation pursuant to Chapter 11 or from any other cause that is chargeable against the Clearing Fund in accordance with the By-Laws and Rules, whether such loss occurs before or after the Corporation gives a notice under this paragraph (a), such loss shall be chargeable against the Clearing Fund as and to the extent provided in the By-Laws and Rules notwithstanding the giving of such notice, and any obligations of Clearing Members resulting from a pro rata charge to the Clearing Fund, including any obligation to make good any deficiency in the Clearing Member's Clearing Fund contribution as the result of a pro rata charge, shall also be included in determining the Clearing Member's Net Settlement Amount.

Item 2. **Procedures of the Self-Regulatory Organization**

The proposed rule change was approved by the Board of Directors of OCC at a meeting held on July 27, 2004.

Questions regarding the proposed rule change should be addressed to Jean Cawley, First Vice-President and Deputy General Counsel, at (312) 322-6269.

Item 3. **Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Action**

Background

OCC has been asked by several of its Clearing Members to consider adopting a rule that would allow for close-out netting of obligations running between OCC and Clearing Members in the event of an OCC insolvency. Such a rule can reduce applicable capital requirements for a Clearing Member's parent company where the parent is a U.S. or non-U.S.

bank. The absence of a "netting agreement" that would apply in an insolvency of OCC can cause the minimum capital requirement applicable to such a parent company and its subsidiaries on a consolidated basis to be substantially larger than it would otherwise be. In the absence of a netting agreement, applicable banking regulations generally prohibit offsetting the Clearing Member's obligations to OCC on short positions in options and other obligations against the Clearing Member's credit exposure to OCC in respect of long options positions and other obligations to the Clearing Member.

It is OCC's understanding that the capital rules applicable to most banks, following guidelines under the Basle Capital Accord relating to bilateral netting (the "Basle Netting Standards"), require that an enforceable netting agreement be in place in order for mutual obligations between a Clearing Member that is a bank affiliate and a counterparty, such as OCC, to be treated on a net basis. The policy behind this requirement is to ensure that obligations that are treated on a net basis for capital purposes can actually be offset against one another in the event of the failure of the counterparty. In the absence of an enforceable netting agreement, there is concern that the representative of the failed counterparty (*i.e.*, OCC, in this scenario) might be able to "cherry pick" under applicable insolvency law by assuming the benefit of contracts representing an asset to the bankruptcy estate while rejecting contracts representing a liability, forcing the non-defaulting counterparty (*i.e.*, the Clearing Member) to perform in full on its liabilities while sharing with other unsecured creditors in any amounts available for distribution from the bankruptcy estate to satisfy its claims. An enforceable netting agreement providing for so-called "close-out netting" in the event of an insolvency of OCC would avoid this potential result, permitting the Clearing Member to receive more favorable capital treatment.

Chapter XI of OCC's rules provides in considerable detail for liquidation of the accounts of an insolvent Clearing Member, including provisions for close-out netting of the Clearing Member's obligations against its assets to the extent permitted by customer protection rules under the Securities Exchange Act of 1934 (the "Exchange Act") and the Commodity Exchange Act (the "CEA"). However, OCC's rules do not presently contain any provisions that specifically permit close-out netting in the event of an insolvency of OCC. Indeed, an OCC insolvency has always been considered so unlikely that OCC's rules do not contain any provisions whatever contemplating such an event. Management does not believe that an OCC insolvency has become any more likely. On the contrary, OCC's long track record of safe operation and continually improved methods of risk management suggest that such an event is more remote than ever. Nevertheless, the Basle Netting Standards make it desirable for OCC to put in place such a netting provision in order to allow Clearing Members subject to regulations adopting these standards to achieve more beneficial capital treatment.

OCC does not believe that a close-out netting rule would directly affect a Clearing Member's net capital computation under SEC Rule 15c3-1. However, OCC believes that enough Clearing Members are or may be affected by the Basle Capital Accord standards through their ownership by entities regulated as banks or bank holding companies to make the proposed adoption of a netting rule desirable for that reason alone. In addition, as noted below, OCC believes that a close-out netting rule would also clarify proper accounting treatment of obligations among OCC and its Clearing Members.

The Basle Netting Standards

The Basle Netting Standards provide that a bank[1] may net transactions subject to any legally valid form of bilateral netting, including netting of bilateral obligations arising from novation, if the bank satisfies its national supervisor that it has a netting contract with the counterparty which creates a single legal obligation, covering all included transactions, such that the bank would have either a claim to receive or obligation to pay only the net sum of the positive and negative mark-to-market values of included individual transactions in the event a counterparty fails to perform due to any . . . default, bankruptcy, liquidation or similar circumstances.

The Basle Netting Standards also require that the bank have certain "written and reasoned legal opinions that, in the event of a legal challenge, the relevant courts and administrative authorities would find the bank's exposure to be the net amount. The national supervisor must be satisfied that the netting is enforceable under the laws of each relevant jurisdiction. The proposed netting rule is intended to support such an opinion.

The Basle standards have been incorporated in applicable bank regulatory laws or regulations in various jurisdictions. For example, the substance of this standard appears in Article 12f of the Swiss Banking Ordinance. It has also been incorporated into the capital guidelines for various U.S. financial institutions.[2]

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[1] These same standards are also applied to bank holding companies.

[2] See, *e.g.*, Regulations of the Office of the Comptroller of the Currency applicable to national banks set forth at 12 C.F.R. Part 3, Appendix A (adopted July 1, 2002), section (3)(b)(5)(ii)(B).

Overview of Proposed Rule Change

The proposed rule change would consist of a single new Section 26 of Article VI of OCC's By-Laws. Consistent with the requirements of the Basle Netting Standards, the netting provision would be applicable in the event that OCC fails to perform its obligations with respect to cleared contracts as the result of defaults by OCC in performing its obligations under its rules, or as the result of bankruptcy, a liquidation of OCC or similar circumstances. The proposed rule is drafted in such a way that it would only be triggered by an event that disabled OCC from rendering full performance under cleared contracts when due. The rule would not be triggered by any delay in performance that is permitted under OCC's rules.

The proposed rule provides that, when a triggering event occurs, rights and obligations within and between accounts of each Clearing Member will be netted to the same extent as if the Clearing Member had been suspended and its accounts were being liquidated under Chapter XI of the Rules. This is an appropriate result in that those rules generally provide for the netting of assets against liabilities to the extent permitted under applicable law, including the customer protection rules referred to above. Assets remaining after all legally permissible offsets would be returned to the Clearing Member entitled to them, and the Clearing Member would remain obligated to OCC only to the extent of any remaining net liabilities following such permitted offsets.

If close-out netting were ever required because of the insolvency of OCC, it seems likely that there would be no market available in which to liquidate positions in cleared contracts through market transactions. Accordingly, the proposed rule contains a provision for valuation of open cleared contracts based upon market values of underlying interests and

provides a reasonable means for OCC to fix all necessary values of assets and liabilities for purposes of the netting. Valuations would be based upon available market information.

FIN 39: Offsetting of Amounts Related to Certain Contracts

In addition to the potential benefit of the proposed rule with respect to Clearing Member's capital requirements under the Basle Accord standards, OCC believes that the proposed rule should also clarify proper accounting treatment of mutual obligations running between OCC and its Clearing Members. OCC's Clearing Members most commonly prepare their financial statements using generally accepted accounting principles ("GAAP"). In March 1992 the Federal Accounting Standards Board ("FASB") issued an interpretation of APB Opinion No. 10 and FASB Statement No. 105 that responds to certain questions relating to the circumstances in which assets and liabilities may be treated as offsetting in financial statements. APB Opinion No. 10 says the following: "it is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of setoff exists." FIN 39 provides a definition of a right of setoff and a statement of the conditions under which a right of setoff exists. The definition is as follows: "A right of setoff is a debtor's legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying against the debt an amount that the other party owes to the debtor." The four conditions under which a right of setoff exists are as follows:

(a) Each of *two* parties owes the other determinable amounts. [Emphasis in original.]

(b) The reporting party has the right to set off the amount owed with the amount owed by the other party.

(c) The reporting party intends to set off.

(d) The right of setoff is enforceable at law.

Condition (a) will clearly be satisfied; rights and obligations with respect to transactions in options are, as a result of contract novation, bilateral between OCC and each of its Clearing Members. Condition (b) will be satisfied upon the adoption of Section 26, which constitutes a netting agreement by which OCC and the Clearing Member are bound. A Clearing Member, as the reporting party, will thus have a right of setoff against OCC to the extent set forth in new Section 26. We may presume that condition (c) will be met in that a Clearing Member would presumably intend to apply setoff to the maximum extent possible in the event of a liquidation of OCC. Condition (d) will require an opinion of counsel, and Section 26 is intended to support an appropriate opinion.

Discussion of Specific Provisions of Section

The text of proposed new Section 26 of Article VI of the By-Laws is largely self-explanatory in light of the foregoing discussion of its purpose. A few comments may nevertheless be helpful.

Section 26(a) allows OCC, if it should ever give notice of its insolvency, to set a Termination Time that is later that the time at which the notice is given. This leaves open at least the theoretical possibility that, if there are trading days or hours left between the time the notice is given and the Termination Time, market participants could attempt to engage in closing transactions at prices determined in the market to avoid being subject to a forced liquidation at prices fixed by OCC.

Section 26 generally provides for netting within and not across different accounts, with specific exceptions set forth in Section 26(d). Where a Clearing Member carries both

proprietary and customer accounts, netting across accounts could be a violation of Rule 15c3-3 and other customer protection rules of the SEC. In addition, CEA segregation rules require separate segregation of customer funds of futures customers. Accordingly, netting across futures segregated funds accounts and other accounts is also generally prohibited. Otherwise, the provisions of Section 26(d) are intended to maximize netting where consistent with customer protection rules. While securities market makers and specialists are generally not customers within the meaning of Rule 15c3-3, they are ordinarily "customers" within the meaning of the SEC's hypothecation rules cited above. OCC has historically not permitted setoff between market-maker accounts and the customers' account in which positions of other securities customers are carried. This separation has been preserved in Section 26(d)(3).

Item 4. **Self-Regulatory Organization's Statement on Burden on Competition**

OCC does not believe that the proposed rule change would impose any burden on competition.

Item 5. **Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participant Exchanges, or Others**

Written comments were not and are not intended to be solicited with respect to the proposed rule change, and none has been received.

Item 6. **Extension of Time Period for Commission Action**

OCC does not consent to an extension of the time period specified in Section 19(b)(2) of the Act.

Item 7. **Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)**

Summary effectiveness and accelerated effectiveness are not sought.

Item 8. **Proposed Rule Change Based on Rules of Another Regulatory Organization or of the Commission**

The proposed rule change is not based on a rule of another self regulatory organization or of the Commission.

Item 9. **Exhibits**

Exhibit 1 Completed notice of the proposed rule change for publication in the Federal Register

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, The Options Clearing Corporation has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

THE OPTIONS CLEARING CORPORATION

By: William H Navin

William H. Navin
Executive Vice-President and
General Counsel